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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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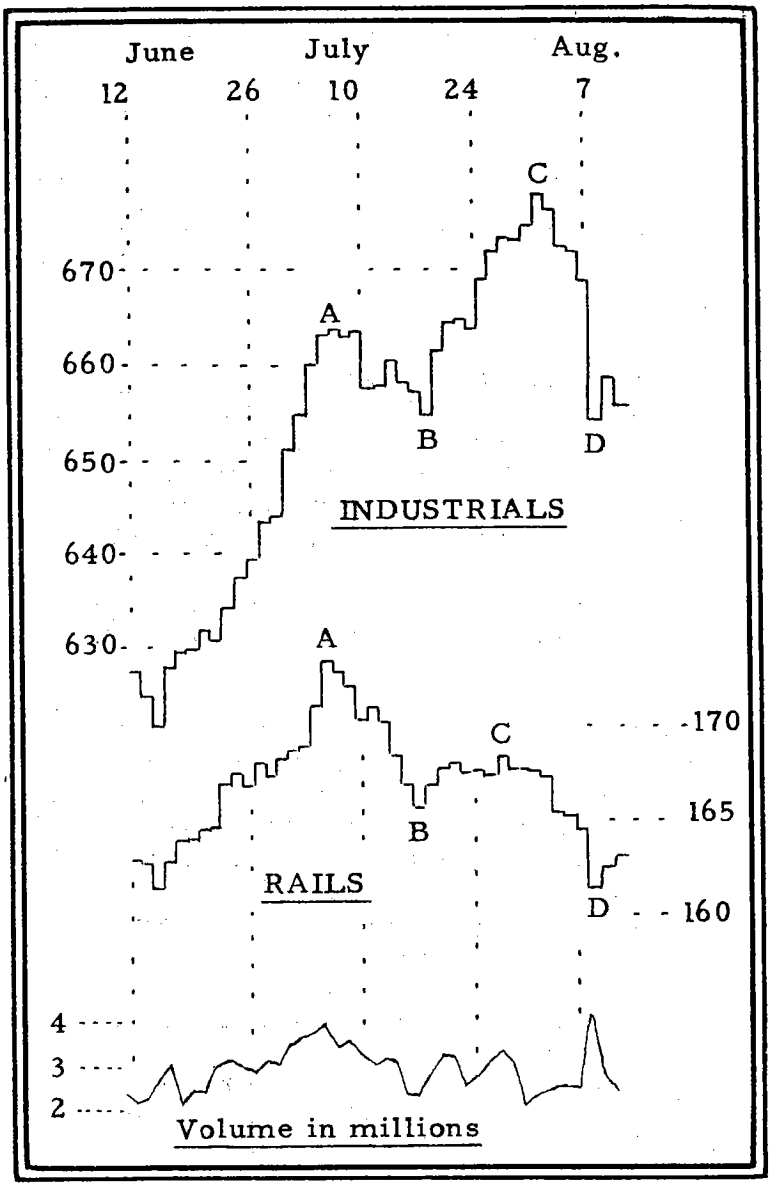
CURRENT MARKET. Last week, following three consecutive days of rail divergence (rails declined while industrials advanced), the carriers turned sharply down and violated their previous decline low at B. On Monday (August 10) industrials confirmed the rail weakness by violating their own decline low at B. The industrial penetration of point B was accompanied by high volume (4.19 million shares), and the panicky one-day drop of 14.78 points was the largest since the Eisenhower heart attack almost four years ago. The sell-off was widely quoted as having been caused by the news of Khrushchev's visit. It is interesting to note, however, that on the preceding Friday this same news was held responsible for the new highs registered on numerous European stock exchanges.

When one average advances to a new high and this high is unconfirmed by the other average, we watch the market carefully. If both averages then turn down (prior to a confirmation) and violate their previous lows on high volume the "danger signals" are flying. At such times the possibility always exists that the secondary trend has turned down. Not every violation of previous lows sets off a reaction (or even a further decline) but a study of previous events suggests that market students should now be on their guard. Furthermore, caution is doubly warranted at this juncture for the following two reasons: (1) the recent dual penetration of the B lows marks the first time in 21 months that both averages, following an unconfirmed high, have turned down and violated previous lows on high volume, (2) this penetration has taken place following an extended and uncorrected advance of 258 points in industrials and 77 points in rails. Whether the C-D drop (see chart) was merely a selling climax following a brief period of uncertainty or whether it was the prelude to something more serious cannot be known at this time. It is enough that the averages have given their warning.

Subsequent to the C-D decline both averages rallied (August 11) as volume dribbled off to 2.9 million shares. A retracement of about half the losses since the highs would now be normal, and since buying is usually hesitant after a violent sell-off, little significance can be attached to the lower volume which may accompany the move back from the D decline lows (industrials 653.79, rails 161.35). Additional danger signals would be: (1) sluggishness in either average on a rally from D, (2) divergence or a refusal of the two averages to move "in gear", (3) volume increasing on an approach to the D lows.

Both averages have now traced definite and well-defined downward zig-zag patterns. A violation of the new D lows would add another downward leg to the pattern, and if this occurs, even more caution would be warranted (particularly if the violation of D was accompanied by increased volume.) If, on the next decline, one or both averages holds above the D lows and volume drops sharply on the approach to the D points, it will be a hopeful sign and the first hint that the selling may be over. But before we can say that the secondary trend is definitely up, it will now be necessary for both averages to better their previous highs (industrials 678.10, rails 173.56).



As to the extent of a secondary, case histories show that secondary reactior tend to correct 1/3 to 2/3 of the previous uncorrected primary advance. Considering that the industrial advance from 419 (Oct. 1957) to 678 (Aug. 1959) has been about 260 points, the advent of a secondary would whittle away many fat profits. For this reason, investors and traders will have to make their own decisions regarding the protection of both short and long term profits. If a full-fledged secondary is in the making, sales at current levels will prove to have been most attractive. If something less than a secondary is in the offing, sales here will have to be chalked off as "insurance" against the possibilities of a severe reaction.

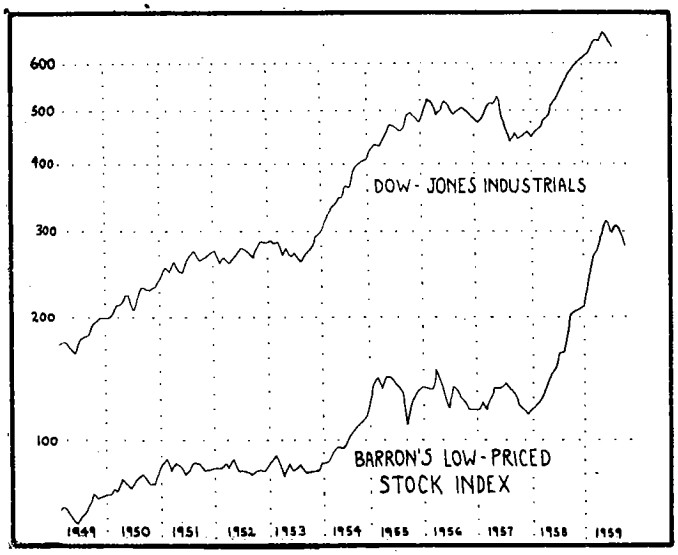
Several subscribers have called to demand that I tell them exactly what is coming up. I only wish I knew. If I were that omniscient I could single-handedly pay off the national debt as well as break every stock exchange in the world. As it is, however, I have merely lightened on an already light position in common stock (I took some "insurance" last week when the rails turned weak).

Older readers are aware of the fruitlessness of attempting to apply financial statistics and "inside" information in order to outguess the price-movements. The market is guided not by spot news or obvious fact but by what the majority of the best informed opinion is able to foresee in the period ahead. The steel strike, Khrushchev's visit, a possible cessation of the cold war, tightening credit -- all of these have been making newspaper headlines, but it is doubtful whether the recent weakness in the market has been caused by any of these "known" factors. At any rate, I have never found it profitable to argue with the averages when they see danger on the horizon.

TRADING TACTICS. I have received correspondence from a few readers concerning substantial paper losses suffered on recent stock purchases. In each case these losses could have been avoided through the observance of two fundamental trading rules. These two rules apply particularly in a market such as the current one, where an extended advance has rendered most stocks vulnerable to individual corrections and the entire market vulnerable to a general correction. As I have states many times, following a great market advance it is extremely difficult to take on new commitments and not show losses in at least a few of the new purchases.

The first rule is: do not average down on a stock. When you buy a stock on a descending scale, you are buying more and more of a decreasing value. The theory of averaging down is that sooner or later the stock will hit bottom and turn up, and the buyer will then have a position in the stock at a low average cost. The flaw in this method of operation is that a given stock does not have to turn up this year or next, and late in a bull market many stocks may top out for the duration of the bull market. By the same token, if the stock continues to drop the purchaser may get panicky and eventually take a big loss on the whole

operation.



The second rule is: unless one is buying near the bottom of a bear market (where good stocks generally sell at depressed prices), limit your losses. DO NOT GET LOCKED IN WITH BIG LOSSES. Veteran traders will willingly take five or six minor losses in order to catch one or two big moves. If the individual stocks or the market continues to move against them, they will write off all their minor losses as "insurance". One or two 50 to 100% gains will more than offset five minor reversals, and only the amateur will get "locked in" with a big loss. Often the neophyte tells himself that he "can't sell" when he is behind; he mysteriously believes his stock must come back because the market owes him money. The market could not be less interested. After registering a few severe losses the amateur may rush back, in an attempt to make up for his reverses. He is seldom successful in this. His type of emotional thinking can only lead to further attrition of capital, and Wall Street thrives on gamblers who are shooting craps for their own excitement rather than investing or speculating with a knowledge of the trend and the individual security fixed firmly in mind.

LOW-PRICED STOCK INDEX. The action of the "cats-and-dogs" provides a reliable gauge of the extent of market speculation. The accompanying chart is drawn on logarithmic or "scale" paper in order to show relative percentages of movements. An advance from 200 to 300 is a far greater percentage move than an advance from 500 to 600, and "scale" paper serves to portray the actual percentage of advance or decline.

As seen on the chart, Barron's Low-Priced Stock Index, starting from its base of 119 in November, 1957, has recently risen to over 300. Thus in a period of 21 months this index has surged better than 250% above its 1957 price. During the same period the D-J industrials (indicative of investment-grade stocks) have risen from 419 to 678 or about 60%. This is perhaps a startling comparison, but it is typical of a bull market's third phase. One of the danger signals which we must now watch for is a topping out of Barron's L.P. Stock Index. Recently a downward zig-zag structure has appeared on this Index, and this may or may not be important. It is, however, the first such structure to appear since the 1957-59 advance began, and for this reason we will pay close attention to the action of this index in the period ahead. Historically, the low-priced stocks may top out a month to many months ahead of the high grade issues, so that the recent weakness in Barron's L.P. Stock Index cannot be ignored.

It is also interesting that whereas the "dogs" usually top in quick reversal patterns (often hitting a high on one day and then dropping precipitously), the investment-grade issues form classical top patterns that may extend over many months. The reason for this is that when large interests (which tend to hold great quantities of high-grade securities) wish to unload, they do so in long, carefully planned campaigns which involve support (buying) in weak markets. The "dogs" are seldom distributed carefully (they are almost never supported) and after hitting their highs they often drop faster than they rose.

STOCKS. After reviewing hundreds of charts, I find it increasingly difficult to find stocks that are worth recommending. Many issues, on the other hand, are near enough to important support levels so that they should be sold if they break. American Airlines--I feel it is a sale at the market. Eastern Airlines -- sell on a close under 36. General Tire -- sell on close under 62. Westinghouse -- sell on close under 87 1/2. American Standard -- sell on a close under 15. U.S. Plywood -- sell on close under 45 1/2. U.S. Gypsum -- sell on close under 100. Would not like to see Radio Corp. break 60 on the downside and would probably sell it if it did. Same with Chrysler on a close under 64.
(Written - Tuesday, August 12, 10 AM)